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PAULA RIEKER	(RIEKER)
UNKNOWN FEMALE	(UF)

(Recording starts, then is cancelled)

UF: Welcome to, (then gets cut off)

BALIGA: ...and stocks and ah, ah, how does it work in terms of ah, like if you're bidding for, like you mention the New York side, ah.....

SKILLING: Right.

BALIGA: .....for he's bid, who are you, you bidding against in terms of getting the logistics ah, network.

SKILLING: Well it would be a way by the competitors and ah, a number of other merchants of natural gas, um, at the time or early on and, and still today the local distribution company might be a competitor for delivering gas, ah, energy companies, producers of oil and gas could have potentially been competitors but there's a whole range of different competitors and the range of assets over time has gotten even more diverse. Ah, early in, early on to provide the liability delivery, delivery to a customer, you really needed to have ah, a lot of term ah, capacity arrangements. You know, we, we'd go to a pipeline carrier who, and we might contract for five years or ten years a firm capacity on that system to deliver to a customer. As time has gone on and as the liquidity and the markets has gotten better, ah, we have been able to reduce the percentage of firm entitlements in the portfolio in favor of temporary or spot entitlements and, and I think the best way of thinking about this is if you can create enough liquidity and so for example deliver gas into New York, I'd probably have

any of several thousand different alternatives to deliver gas into New York, ah, because I have so many alternatives, ah, I'd diversified away the non-systematic risk of delivery and non-systematic risk in our business is basically a, a supply interruption so I can use more ah, spot transportation arrangements per unit of the reliability than my competitors can because I have more alternatives, I've more options for delivering and more roots, more logistic roots then I can choose to deliver the product, ah, on the producer (inaudible).....

BALIGA: (Inaudible) do you have variable cost?

SKILLING: I'm sorry?

BALIGA: The costs have actually gone from fixed costs to variable costs?

SKILLING: Yeah, so that, so that instead of in the old days if I wanted to sell ah, 30 million cubic feet of gas a day into New York City I'd probably would have needed to get 25 million a day of firm capacity you know? In the old days on a pipeline network that probably would have cost me from the Gulf Coast maybe \$1.10, \$1.25. Ah, today to, to give that same degree of reliability, I'd probably only need to purchase two or three million cubic feet a day as an absolute backup system and I can go into the temporary or cash markets and, you know, usually there's some distressed capacity floating around and I might be able to pick that up for 20 or 25 cents, ah.....

NORDBY: Per (inaudible)

SKILLING: Per million.

NORDBY: So what, can I just ah, ah, ask you on this point, the implication is that you would be less dependent upon the actual commodity price at price volatility if I'm understanding this right, is, is that correct or not?

SKILLING: Yeah, the underlining commodity price has absolutely zero impact on our income. Zero. Ah, ah, ah, you can look at correlations of this profitability, particularly look at our Wholesale business, if you look at correlations of profitability to price you'll get an R square of zero. Ah, what really impacts us is the ability to find the lowest cost sourcing and the more alternatives we have the ah, more profit we make. Now volatility does enter into it, ah, Dan, and the reason volatility enters into it is in periods of high volatility, ah, those different alternatives are more valuable. You know, for example, ah, in Southern California gas prices, ah, bounced from \$3.25 up to in some cases \$60.00 a million BTUs, ah, in January and February. Well, ah, when you have that kind of a jump and you're obviously scouring the world for the lowest cost ways of delivering ah, product into that market place, the volatility helps. Volatility is good in those cash markets, now, I will say and, and, and this

goes to one of the questions that, that Paula said that you had is ah, what's the impact on our profits and volume growth in a low volatility environment? When things change to low volatility, other types of alternatives become ah, attractive. You know, for example today, ah, when you have prices as volatile as they've been and at levels that they've been, ah, it is virtually impossible for us to cost justify the purchase of ah, ah, of capacity. Ah, of ah, you know, in the electric markets the generating facility is the, is in some ways a logistics asset because it gives you access to the commodity, ah, at a location. But we just can't get to the numbers, ah, that people see today.....

BALIGA: (Unintelligible)

SKILLING: .....we are paying enormous, enormous premiums ah, for generating capacity, we just don't see that. If we move to a period of much lower prices and lower volatility what we found is the asset markets move from being a ah, seller's market to being a buyer's market. And so for example in the late 90s, ah, we did lots of transactions relating to ah, capacity and assets, ah, when the volatility in the markets, ah, in the cash markets went down so, the model I've used, ah, you know look at our European operations, which I think is the perfect example of that. Volatility in the European, European markets is basically non-existent. Ah, the markets are in massive over capacity ah, for electricity. And, we've had our strongest growth of any market in the world, ah, in Europe and interestingly our margin per unit of energy delivered, not margin per dollar of revenue because the underlying commodity price is irrelevant, but if you take our margin per million BTUs of energy delivered, ah, in Europe last June was virtually identical to what it was in North America. In spite of the fact.....

BALIGA: Can I, can I, can I.....

SKILLING: .....that the market is ah.....

BALIGA: .....Can I understand a P/L issue then? In California where the price of ah, natural gas was 60 bucks.

SKILLING: Um hum.

BALIGA: So you charge, I mean on your, on your revenue line, if you're basically selling some of the California utilities and natural gas, does that show up at 60 plus whatever charges that you make? At that unit.....

SKILLING: Yeah.

BALIGA: That you apply to them?

SKILLING: Yeah (inaudible)

BALIGA: At, at, if you start at the back.....

SKILLING: I'm sorry?

BALIGA: So if it's a dollar so actually, your revenue line would show \$61.00, \$61.00 and your cost if it was sold would show 60 correct?

SKILLING: Correct. Yeah probably, yeah probably the best way of thinking about it is in the, in the market where gas is selling in California for say 3 and a half dollars?

BALIGA: Right.

SKILLING: We would show a revenue number of 3 and a half dollars.

BALIGA: Right.

SKILLING: And our cost number would probably three and a quarter.

BALIGA: Okay.

SKILLING: Okay?

BALIGA: Okay.

SKILLING: In a \$60.00 market, our revenue line would show \$60.00 and our cost line might show \$59.25, you know, and you get, ah, ah, whatever the, I was trying to make it come out the same, I feel as though.....

NORDBY: Now, now that's why your, and that's why your revenue line is largely irrelevant, here.

SKILLING: Right, revenue is irrelevant but look at, look at margin per unit of energy delivered, which, which is really the logistics indicator and it runs about 11 and a half cents per million BTUs and it's been, you know, it's been as high in the early 1990s as ah, I think 13 cents and it's been as low as I think we got down to 9.9 cents in the late 1990's but it's, you know, ah, 10, 11 cents per million BTUs is a, is a pretty good, that's, that's the count on number now as I mentioned in Europe which is the opposite of the North American markets, there is no volatility there, we've run about 12 cents in Europe. But ah, but, but.....

KAMP: Yeah but Jeff, but Jeff isn't it true that you benefit in a rising, ah, commodity price environment more so than you would in a falling commodity pricing, price environment? Why wouldn't you be exposed in a falling commodity price environment?

SKILLING: Ah, well that, you know it, it just isn't the case, I mean, we don't have a commodity exposure, ah, I don't care if prices go up or down, all I care is that that I'm delivering a lot of product to my customer and that I can, that I can source that product at a margin you know and, and the price of \$60.00, you know I'm, I'm kind of in a same position as when the price is \$5.00, it doesn't, it doesn't really matter very much. You know, in fact again I, I, I gotta, I gotta give you an analogies for it, you know, take Europe, ah, no volatility, low prices, we have the same margin we have in North Amer, America, with high volatility, high prices. We've built the natural gas business in the late 80s and the early 90s, a period of secularly declining energy prices, that was probably our highest growth and most profitable years.

KAMP: But ah....

SKILLING: So we started the electricity business in 1994, prices dropped by about 60% between 1994 and 1999 in the electricity markets that's when we, that's when we created the business.

KAMP: No, no, but the (inaudible)

SKILLING: (Inaudible) oh.

KAMP: To the extent that you contract for a certain amount of capacity, ah.

SKILLING: Right.

KAMP: For, ah let's say for a very hot summer. And then it.....

SKILLING: Right.

KAMP: .....turns out to be a very cool summer and the demand for that amount of energy is not there. You're left.....

SKILLING: Right.

KAMP: .....holding ex, the energy at higher prices than what ultimately turned out to be the case.

SKILLING: But see I won't contract for that capacity, ah, in other words I won't purchase the

capacity unless I've already sold it to somebody. Right, in other words I'm balancing my position, in, in, in other words if you're a customer and you come to me and you say gee I wanna buy ah, you know ah, 10 million cubic feet of gas a day, it's at that point that I'll go out and execute, you know, I'll, I'll agree with the price, figure out a price with you and what the economics are and it's at that point that I'll go out and arrange the logistics to back it up so ah, the positions are balanced, the capacity positions are balanced, it, this is, and it's probably the most important point, I, I hope you take away from this. We have a unique strategy relative to any other merchant you know if you compare us to Reliant or Dynegy or Merantz or whatever the name, all the other people, in every single case they have a significant commodity price exposure in their portfolio and ah, you know.....

KAMP: It's my impression that Goldman does, as well.

SKILLING: I'm sorry.

KAMP: It's my impression that Goldman has a significant commodity exposure as well.

SKILLING: Well they, they should because they're in a joint venture something called constellation, ah, with ah, Baltimore Gas and Electric and as I understand it, ah, Baltimore Gas and Electric is transferring their generating assets into that joint venture so they will have an enormous long position. As I understand it, ah, yeah in electricity.

BALIGA: But Jeff, I mean is it the right to presume that in ah, the six, the sixth month of last year and the 1st, ah, 45, ah, days of this year, ah, I mean a quarter of this year, you did not earn any ah, incremental earnings from the California problem?

SKILLING: Ah, I'm sorry, say that again?

BALIGA: You did not earn any excess profits, ah, I mean your earnings were not impacted at all by the spike in energy prices?

SKILLING: Well our volumes were way up in California.....

BALIGA: Okay.

SKILLING: ....yeah we made money in California by delivering more volume to the customers.

BALIGA: Yeah, I know I, I....

SKILLING: You know if you have the volume.....

BALIGA: You mean like, ah, ah, let's keep volume aside, but if the volumes are the constant you would not have had actually earned any kind of money in the spike in the price war or the, the price of gas.

SKILLING: I think if you take our entire Western market position, I would imagine in the physical market the delivery of natural gas and electricity to customers, I would guess we were about even on a price basis over that time period, would be my guess, best guess.

NORDBY: Jeff, this might be a good ah, segue into ah...

SKILLING: In, in fact, ah, if you, if you wouldn't mind.....

NORDBY: Okay.

SKILLING: .....just one indicator that, just, just so you guys can confirm that. One way of checking that, of, of looking at what that exposure is, is ah, is going through the records of the California ISO and PX, you know for scheduling of power into and out of California and in fact they're now, they're publishing all of this because this is the basis of the refund, the refund claims that California is using, ah, to go back and they're asking for money back from, from ah, people who sold ah, power into California, ah, they're claiming there's \$8.9 billion dollars and I will say the entire calculation is bogus but they're basically using actual volume data, data, ah, they went through the ah, California ISO but they're asking for \$8.9 billion dollars back and there's some big numbers in there. You know I think Reliant, ah, they say owes them seven hundred million dollars and ah, I think Dynegy owes them 400 million, I mean there's, there's some pretty sizeable numbers in there that would, that would be an indicator of a commodity price position in California. They say we owe them \$39.5 million dollars so we're like .4% of that outstanding balance. By our calculations we were in fact a net purchaser of power, ah, from the ISO for the time period because we actually, we have end use customers in California that's how we manage our position in California, we actually have direct access customers in California. By our calculations, we were in fact a net purchaser of power from the ISO which means that, that if they're successful in getting their refunds, then they have to give us \$40 million dollars so if you look at our net position as indicated by those numbers, you'll see in a radically different position, we're in a totally different position, ah, from the other supposed, you know, merchants of, of power in California.

NORDBY: Okay. Ah, help us understand a little better if you would the whole risk management system, ah, that the company uses because you know, it, let's, let's accept that there is little commodity price risk and let's accept that there is little

volatility with, you obviously have some macro economic risk, we all do. Ah, but it would seem to me that your counter party credit worthiness is an important part of this, how, how do you manage your, your risk ah, risk system here?

SKILLING: Yeah. Yeah, in fact it, it is essentially if you look at economic implications what we do is essentially converting price risk into credit risk, right? I mean we're essentially, when we contract with a customer for firm prices, essentially what we're doing is in in, and, and when we back that with a firm purchase, we're converting a price risk into a credit risk so the, the major risk that's embedded in our earnings is a credit risk problem, ah, a credit risk issue. Ah, and that's just nature about, about the role we carry out in the business, what we do is every day at the end of the day, ah, we calculate based on what current prices are for the commodity, how much in or out of the money all of our contracts are with all of our counterparts and we have some great systems, should you come to Houston I'd love to show them to you because we're very proud of them but calculate what the total credit exposure is by counterpart for every person we do business with and then we have an internal credit rating system where we assign to all of our counterparties a rating from 1 to 12 and those ratings from 1 to 12 really correspond to ah, risk, essentially payment risks of customers. Each of those 12 categories ah, has a real time estimate of default rates associated with it where we actually look at benchmark securities that are similar to the credit of the ah, counterparty that we have, look at what their yield is relative to risk free rates which gives us some indication of the market's view of their likelihood of default, we assign that same number, that same default likelihood, ah, to those risks and then we multiply it all out and at the end of the day we determine what a required credit reserve is to support ah, that credit outstanding and then that credit reserve is deducted from the income from the day. And so if you go on our balance sheet, you'll see a total receivables and then there'll be a credit reserve number and that credit reserve is a real time calculated ah, default probability for the portfolio.

KAMP: And it's done each day?

SKILLING: Each day, yeah.

WALLACE: Hey Dan?

NORDBY: Yeah.

WALLACE: Can I jump in and ask a quick question?

NORDBY: Please.

WALLACE: Ah, just, just a quick question on the, on the ah, commodity price exposure again,



just so I understand clearly what's going on here. Ah, ah, I think last year in, in your 10K or whatever it was you disclosed that your average daily value at risk for the for the overall portfolio contracts you have was something like \$60 million dollars, I believe.

SKILLING: Yes that's right.

WALLACE: Ah, and if I understand how that's calculated, I think it assumes a 10% move in the underlining commodity and therefore you kind of theoretically calculate what that means for your P/L. Ah, is that?

SKILLING: Yeah I know.

WALLACE: Am I understanding that right?

SKILLING: Well you, you have the number exactly right, the value at risk last year was about \$60 million, the value at risk is, it's, technically it's a 95% confidence interval so ah, it's your daily, it's given the position that you have that day rather it's long or short, it's the ah, 95th percentile, ah, it's actually the 5% ah, maximum daily risk in a portfolio, so a way of looking at that is that would say one day out of every 20 with a VAR of \$60 million dollars would expect to lose \$60 million dollars based on the imbalance in the portfolio.

WALLACE: Right. Right, so I guess a simple minded way how do you get from that calculation to an understanding that you're kind of not really exposed to commodity price risk?

SKILLING: Well it, because you don't at any given time, see what we do as we put together buyers and sellers and there's never a perfect match, ah, you know there'll, there'll always be an imbalance and that's, that's part of how you make money because a customer calls up and they wanna buy gas and you say okay it's done, well from the period of time when you say fine you got the gas till the time that you go out and buy the gas there may be a time gap there. Ah, now it may be that the time gap is the other way, ah, a customer is coming in and saying, I'm sorry, I want to sell you gas and then it takes you a period of time before you can, ah, sell that gas to some third party so that, the \$60 million dollars is a, a, ah, a mathematical calculation of how much imbalance there is in a portfolio. At any given time the odds that that portfolio is long or that portfolio is short is probably about 50:50. It's all a function of this clearing the purchases and sales of the customer so on any given day I can't tell you if the prices go up or down, I don't know if I'm happy or sad but I know I'm slightly out of balance, ah, it's just, you know, the nature of the, of the business.

KOENIG: But the \$60 million is the aggregate number which includes all of our commodities and there's actually sub VAR books for everything it's not one \$60 million dollar...

BALIGA: Liability.

SKILLING: ...VAR exposure.

UM: Yeah, yeah, yeah.....

SKILLING: (Inaudible)

BALIGA: ....a, a VAR exposure that you would take on any (inaudible) a day.

SKILLING: Ah, our, our current limit, the, the theoretical maximum limit and this is, this is the Board policy limit right now is about \$125 million dollars and I, I think the average use of VAR, ah, which means that just given when people are buying and selling, ah, the average use of VAR runs about 52%, 52 to 56% so on a typical day you'd expect to see about \$60 million dollars of ah, of net exposure on the portfolio.

BALIGA: And that has not changed despite the fact that your volumes have increased and your revenue stream is actually increased and so on.

SKILLING: Ah, well I think we actually, we, we might have brought the VAR number by the percentage of, of ah, volume increase just so. In other words you, you expect your VAR. If the VAR were a function of commodity prices, you expect it to move with commodity prices. It doesn't, it move with our volumes, in other words we're doing 30% more volume, ah, just to maintain the same sort of, of a liquidity for our customers you'd probably would expect it to go up something under 30% because it gets bigger you're getting more liquidity so you need less VAR so. You would expect to find, I mean, this is where scale comes in, you know we're in an intermediation business and intermediation business tend towards scale and one of the reasons they tend towards scale is that they're really efficiencies, the bigger your portfolio's relative to your competitor and so it's, it's like net checks, you know ah, if your net checks, if you got 2,000 planes in the air, and your competitor's got five.

BALIGA: Um hum.

SKILLING: It is so much cheaper for you to make a plane available for that competitor then that competitor, then that competitor then you can charge the same prices as that competitor and you make a ton of money, you'll just have more liquidity in the system.

BALIGA: Um hum.

SKILLING: So the most important thing that drives our competitive margins is our relative

market share and ah, you know the last year we significantly improved relative market share, a year and a half ago, we were probably one and a half times as big as the next biggest player. Ah, right now we're, we're over three times as big as the next biggest player, that translates into tangible improvement in margins, in, improvement in relative margin.

NORDBY: Jeff, would you tie VAR and, and ah, what we've just been talking about into the cash flow because it was some confusion about the businesses' cash flow and a lot of that had to do with deposits that you have apparently required or don't require in.....

SKILLING: Yeah.

NORDBY: .....a very difficult pricing environment, could we just ah, go over that again?

SKILLING: Yeah, well what happens that, that same daily calculation that I mentioned when we determined what our credit reserves are, in addition to that ah, we have in our contracts with, with our counter parties we have provisions that if at the end of the day, ah, their, the amount of money that they owes us reaches a certain level, ah, we can call on cash deposits from those customers, ah, to support that credit exposure or we shut down business with them and we, we liquidate their position so ah, at the end of last year in the 4th quarter of last year when prices and, in all of the country went up to unprecedented levels for natural gas and for power, we called on deposits from all of our customers and so you, you saw in the 4th quarter of last year. This has never been a big item because we've never seen such a big fly up in prices as we saw in the 4th quarter but in the 4th quarter of last year, we drew in about almost \$2 billion dollars of deposits. Now the way that shows up in the accounting we didn't realize it was a big item or we would have broken it out previous to now but it just shows up as cash flow from operations but what it was they give us the cash, it's like they're prepaying what they owe us. Well when prices came back down in the first quarter, the \$2 billion flowed back to those customers and so ah, what, what we're actually doing and looking at our cash flow statements just net out those deposits, that is, that is purely a timing issue and it's just a function as to what prices are and it's, it's like a prepayment, it just comes and goes depending on what the price levels are in the market place. If you, if you, if you adjust to that, in other words if you look at the line which would be cash flow from operations before deposits, what you'll see is we had ah, in the first half of this year we, we are probably in a record cash generation level, I mean the highest level we've ever had the first half, ah, in the company. And there'll be some lumpiness and ah, and the reason there's some lumpiness in the cash flow is that ah, we recognize just, just based on the latest portfolio which we recognize ah, income as the mark to market value of that portfolio. So at the end of every day when we do that calculation, we figure out what we owe other people and what they owe us

and the difference is what our profitability is and the change in that difference is what our profitability for that day is.

NORDBY: Well going, going on.....

SKILLING: Depending on what the...

NORDBY: Go, go ahead.

SKILLING: Sorry.

NORDBY: No please go ahead.

SKILLING: Anyway, okay. Ah, but anyway, depending on what the term structure is of those, of that, of that ah, that differential of that future cash flow, ah, you'll have a timing difference between recognition of income and when cash actually comes in the door. Now we have closed that gap, we do that ah, ourselves, what we do is that typically towards the end of the year we monetize those contracts just to bring the cash in so what we do is we go out essentially to a financial institution or through a sale of purchase of an additional contract, what we do is we go out to ah, to them and say hey look, here's, here's a five year purchase contract, here's a five year sales contract, there's a gap between them, you can take both of those contracts, just discount it for credit risk and give us the cash and so we basically we're selling the net position to the customers. And, and, and we do that typically toward the end of the year and that's when we, when we close the gap of timing between ah, income recognition and cash generation.

NORDBY: Going forward, are you going to ah.....

SKILLING: Is that what we.....

NORDBY: ...differentiate between the cash deposits and, and cash form operations, ah, or, or not necessarily?

SKILLING: Yeah we will, we'll put it, we just didn't realize it was an issue Dan. So, it'll be in the income, it'll be in the balance sheet from now on, see it will be on the cash flow statement, so you can print it out.

BALIGA: The, the sale off of a contract, I mean does, where does that appear on the, ah, in terms of income statement? And how, how.....

SKILLING: What, say that again?

BALIGA: How come, how big of an item is that? I mean does that consider, consider an asset?

SKILLING: Now see it, it doesn't impact the income statement, the income is recognized when you have a completed or executed contract for purchase and sale you've locked in the differential, that's when it, that's when it shows up as income.

UM: Okay?

SKILLING: It will, now it will impact when it shows up as cash because the cash will come in as that contract ah, liquidates or if we presell the contract to speed up the cash flow.

BALIGA: Right. So when you, when you sell the, when you sell the purchase, let's say you have a five year contract with delivery and a five year contract for ah, for usage. And you're locking in a \$100 million dollars on this. Net off.....

SKILLING: Right.

BALIGA: .....net off the credit risk. So where does that.....

SKILLING: Right.

BALIGA: .....does that, does that \$100 million actually come on as a P/L or, or as a sale of assets or?

SKILLING: No it, it just an operating in, an operating.....

BALIGA: (Inaudible)

SKILLING: .....in a, (inaudible) as the gross margin. That's the gross margin.

BALIGA: And how much, how much of these do we normally ah, consider to be off, ah, like ah, ongoing operating with us one time?

SKILLING: Well they're all ongoing, I mean this is, this just the management, you know, the daily management of portfolio, I mean that's, that's what we do, we make and sell contracts.

BALIGA: I see.

NORDBY: Ah, I and then ah, I'd like to kind of go a couple of other directions unless people on the call wanna pursue this particular area. Do we have other, Scott or Guru do you have other questions or?

BALIGA: Yeah I'm just, yeah because I'm, I'm just a bit confused, I mean like this is like actually you know I know the sale of assets but I thought, ah, when you're doing this, um, you know first of all when ah, if, if you're trying to look at it as a growth company, we need to understand, I mean you know, how many of these contracts are there all the time, how do you actually get a, a comfort level that your earning stream is actually a 20% growth earning stream, or something like that because you need to actually get a, a comfort level that you're going to maintain the same kind of stress on every contract that you put on.

SKILLING: Right. Yeah well I think what you look at, yeah, the, the number that shows up is volumes, volumes delivered and millions of BTU's, that's the number, er, volumes of millions of BTU's that are settled every month.

BALIGA: Okay.

SKILLING: Okay so that number shows you what the growth is in the underlying business and that's what, that's what predicts the growth of the company and the volumes have been great, I mean we've been up 50, 60% in overall volumes in the wholesale business ah, for the last two years now I guess and, and over the last decade the number's been about 30% compounded volume growth and that.....

BALIGA: Okay.

SKILLING: You know some of those contracts are one day contracts, some are five day contracts, some are one month contracts, some are five year contracts and it's just, you know, it's just an overall portfolio of these contracts, all you have to look at is the volume that's going, going through the system and that's shown the physical volumes delivered, ah, calculation.

NORDBY: And that's really the metric on which we ought to ah, track your progress right? Volumes?

SKILLING: Yeah, Yes and ah, ah, if you had taken that number and multiple it by 11 and a half cents you'll get our number in the wholesale business.

BALIGA: But Jeff, I mean a five, a five year contract for 100 million, ah, for a 100 million BTU's...

SKILLING: Yeah.

BALIGA: ...per year. Is that calculated into five times the hundred times, ah, I, I mean are you sure that's five hundred?

SKILLING: No the five hundred.....

BALIGA: Or is the volume 600?

SKILLING: No the volumes, the volume number is physical delivery.

BALIGA: Okay.

SKILLING: So that, you know, if you had a five year contract that would be, you know, what was physically delivered during the month.

BALIGA: Okay.

SKILLING: And so the only thing that, that should influence that margin, one thing that could influence the margin would be a change in the average maturity.....

UM: Right.

SKILLING: .....of business that you're doing.

UM: Right.

SKILLING: And quite frankly it's been pretty flat for about the last four or five years and I don't, I don't have the exact number of what it is right now, it's about, it's probably about three and a quarter years. Something like that would be the average maturity.

NORDBY: How much more do things have to slow down in a macro economic sense before volume growth is, is threatened?

SKILLING: Ah, it, it really doesn't matter very much, ah, what impacts our growth rate is not the overall growth in gas and electric, I'll take that, ah, let me give you, let me see if I can describe this. Our growth is driven not by the overall growth in the energy market it's grown by the ah, it, it grows consistent with the growth in the non-regulated portion of the energy market and, and let me see if I can describe that. If you went back to the natural gas business in 1985, 100% or almost 100% of the sales of natural gas since 1985 were regulated sales of natural gas. Starting at around 1985 to 1986, we created the non-regulated market for natural gas and so if you went to 1987, even though the natural gas market was shrinking at the time, the non-regulated natural gas market was growing by leaps and bounds because we were basically taking over from the regulated business so the thing that drives our growth rates and physical volumes is the conversion of markets from regulated to non-regulated. Now the markets are at various stages of that conversion, ah, the more mature market, the most mature market that we're in is the North American

Natural Gas Market and essentially 100% of that market has now converted to non-regulated structures okay? So in the North, North American natural gas market, our growth rate now will be totally dependant upon the overall natural gas growth and change in our market share, that will dictate whatever our growth rate is from now on. And overall North American gas market is going on okay 3%, something like that, our market share has grown very fast and so we've been able to keep very fast growth in natural gas. Our electricity in North American is totally different ball game. The electricity probably only about 20% of the market has converted so if we just hang on to our current market share over the next three to five years as we go from 20%, or 25% up to ah, 100%, our volumes in electricity should go up by a factor of 4 or 5, ah, if we just maintain our market share. You know in, in Europe ah, it's even less developed probably the total gas and electricity markets together which are probably as big as the North American markets are only about 10% converted. So even if, even if the ah, the demand for gas and electricity shrinks over the next five years, we should still be showing, showing extremely strong growth if we hang on to our market share and these markets continue to convert from the regulated markets into the non-regulated markets.

NORDBY: And, and are we safe in assuming, and I think you even addressed it at your conference, ah, that the recent FERC rulings which obviously implied the government's position on this, despite the headline price caps on the specific issues in California actually have a body of regulation that further deregulates this and accrues to your benefit. Is that a safe initiative?

SKILLING: Yes. Yeah the FERC has been virtually inactive on opening markets at the wholesale level for the last two and a half years until two weeks ago and ah, two and a half weeks ago. They issued a new order. Under the new order, they're mandating the formation of four of what they call, they call them regional transmission organizations. By our estimate, this will open the market for ah, wholesale power from that 20 to 25% that I've mentioned a minute ago to somewhere in the 80 to 90% range, ah, so essentially from a regulatory standpoint, we now have a free path toward opening up ah, the rest of the wholesale markets for ah, for power in North America, Europe still raises some additional regulatory things but they're moving in the right direction, now I will, I will say this, I know this is confusing, anytime I get regulation involved it gets confusing but everything we've been talking about till now is wholesale. Ah, it's my contention, and I think this latest FERC ruling will prove it, the wholesale markets are rapidly opening up. They're becoming much more efficient, much more open to competition, and so at the wholesale level, ah, regulatory light is green, our growth, ah, ah, rate is green, ah, we've got enormous market ahead of us in the electricity markets in the North America and the European markets so we're in great shape with the wholesale markets, now at the retail level it's a little different story. Ah, the retail markets are not regulated by the federal government, they're regulated typically by



state governments, ah, in the U.S. and, and even outside of the U.S. And so there, that's what's going on in California so when you hear people say that some of the states are backing away from deregulation, they're really talking about that retail regulation. And I think it is probably fair to say that at the state level, ah, if a state does not currently have legislation or regulation in place to open the markets, ah, it's my guess that they're gonna slow it down. You know if, if the state has not approved that now, they're gonna wait for a while and see what happens in California before they, ah, before they open any further. So what that means is the retail markets will probably be opening somewhat slower than what we'd expected, the wholesale markets will probably gonna open faster than what we expected, ah, I don't think that impacts us much at the retail level, our, our retail business called Enron Energy Services is kind of an outsourcing, ah, energy outsourcing business, ah, we are such a small component of that market right now that we, we have plenty of states that have opened to keep us busy for the next couple of years. And two or three years from now, I'd like to see continued progress against opening of the states but I don't think that really impacts that growth rate too, too much ah, over the next couple of years.

FRICK: Is that 80 or 90% of the wholesale market that opens up because of the FERC deregulation open up immediately or does it open up over staged phased?

SKILLING: It'll be stages phases, ah, there, they've mandated two RTOs to be up and running by early 2003, which means we should be seeing some pretty good movement starting the middle of ah, ah, probably the middle of ah, next year we'll see a lot of opening of the markets so, and then the next two are supposed to be done by the end of 2003 so over the next. It doesn't make much difference over the next 6 months, and I think that's fine because we got tremendous momentum right now in the wholesale markets, but starting the, you know, the first, you know, the first or second quarter of next year through 2003 you'll see a real acceleration in the opening of those markets.

BALIGA: When you look at the competition, um, it, it, I, I guess ah, the, the way we should actually look at this is that the market is opening up and ah, you are one of the leaders and therefore you should act right away or should we also be concerned about, like pricing on the contract, coming to come down because it's, now becomes to know ah, a lot more opportunities gonna bring in a lot more competitors and what are the risks of that kind of thing happening is that pricing goes down into tubes like ah.

SKILLING: Right. Well see these markets have been opened for a while, gas really started opening back in '87, in 1988 there were 300 registered marketing affiliates in natural gas, in, by 1996 there were probably 300 registered marketing affiliates for electricity. The industry is actually concentrated quite a bit since then, we've

shaken out a lot of the weak players, and ah, you know, our relative market share is just gone through leaps and bounds recently, I, I think it may be the opposite, I think we're.....

UM: But the accurate.....

SKILLING: ....I think we've tied up the stakes.

UM: But how.....

SKILLING: Now that we've shaken out all of the, all of the ah, really weak players and I, you know, I think margins will be pretty good from here. Ah, I, I, if you ask.....

BALIGA: But if you were to look at you all's 12 cents per a million BTU's, and is, is that kind of been the same across from 1985, '86 or has that actually come down?

SKILLING: Yeah I've got, I've got the numbers, I'll read these numbers off to you, ah, ah, I've got back to 1990 on these numbers, let me, let me just, just tell you what they are, ah, so I, I, so just start from 1990 and I'll start reading them off to you, if you write, if you can write real fast okay?

NORDBY: Okay.

SKILLING: Okay in 1991, ah, I'm sorry, start in 1991, it was 14.6 cents, 1992 it was 15.7, 1993 it was 13.7, 1994 it was 12.6, 1995 it was 12.2, '96 it was 10.3, '97 it was 9.6, '98 it was 9.4, '99 it was 11.1, 2000 it was 11.9, and the first 6 months of this year it was 11.8.

NORDBY: Yeah that's, that's persuasive. Let, let me ask ah, ah, a very naive question, ah, if nuclear power were to make a significant come back, ah, ah, how does that affect you or change your business model here?

SKILLING: Ah, well, I'll, I'll tell you I'm real skeptical about it but you know from the, from the day they decided they wanted to build a new nuclear power plant till the thing comes online, it's, you're probably talking 15 to 20 years, ah, I'm not sure I'll still be alive then. (Laughs)

NORDBY: (Laughs) Still hopefully.

SKILLING: Ah, well I hope so but you, you never know, but I, I really don't think of it as too much action in nuclear to be quite honest. I mean the Bush Administration talks about it more to try to keep existing facilities licensed then they are about building new ones, I don't think anyone in their right mind would build a nuclear power

plant today. Hey look at the construction costs, ah, the most recent plants have been completed like South Texas and, and ah, Texas had a total im, imbedded costs, you should take all maintenance and capital and probably running into the 12 to 13 cents per kilowatt hour so that's 120 to 130 cents, ah, 120 to 130 dollars per mega watt hour, that compares to gas combined cycle even at \$4 dollar gas probably closer to \$40 dollars, \$45 dollars so it's just not cost effective.

NORDBY: Okay. Ah, a couple of ah, other areas that people wanna ask about in this area before we move on. Ah, can we just touch on the, on the insider selling issue, I, I know that ah, I, I was the bad boy that brought that up at the meeting, ah, you, you've looked at some of the numbers, um, where, where do we stand on that?

SKILLING: Yeah I, I can, I can kind of tell you what kind of goes on at Enron, we have a lot of people, I, I'll use myself as an example Dan, I, I mean I've been with the company since 1990, was with McKinsey for 10 years before that working on this issue, ah, with the company and ah, I was a little concerned about the equity markets in general and, and quite frankly they've haven't done anywhere near as poorly as I expected them, ah, to do. Ah, so I had an interest not to build a new house and all that stuff so I wanted to sell some stock well it turns out at Enron, um, we had these windows that are closed most of the time because of, of ah inside information, we're, you know, we're always doing something so it's kind of hard to get a window. The FTC came up with this new ruling that I think you guys are familiar with, it said that if you file a sales plan, you know, kind of a consist sales plan, you had a safe harbor, which meant that as long as that plan was filed, and you had no material inside information, then it was assumed and, and as long as that plan continued, it could continue in spite of the fact that he got material inside information so most of the senior executives in Enron kind of in the September, October range, ah, time last year started to file some of these plans and, and I did it was first, you know, what I mean is relatively small sale of stock, ah, on a weekly basis going out over time. What happened though they regist, they registered when the registering sales for insider purposes, the registered the entire plan up front and so ah, a lot of numbers were coming out that some people were registering plans with big numbers and Ken Rice for example registered a plan that said that ah, if the stock price are over \$90 dollars or something he was gonna sell like 10,000 or 20,000 shares a week, ah, but if the stock price was under \$70, he would sell zero, well he ended up selling zero under that plan but you know it showed up as a big intention to sell a bunch of stock so the ah, the numbers are a whole lot less I think then what people represented them to be, I will tell you that, I, I can tell you my own case I have stopped my plan, I had stock prices ludicrously low, like Ken Lay has terminated his plan, and, and to give you a sense for it. I got my latest book, I've got about 85% of my net worth in Enron stock and so I, you know, I can't be ah, and talking about putting your money where your mouth is, I'm not sure what else I can do, you know, at this price I think stock's a great buy

at this price. Ah, now we have had a number of executives leaving and that's, and that's another thing that's happened, ah, you asked one question here about capital allocation and a return on capital, ah, and to really, we created two new businesses back in the late 80's, one is this merchant business who we just spent all of the time talking about but we also created a business then that was an international development business which was basically in most, mostly third world countries building ah, developing and building and operating ah, power plants and gas pipelines. Ah, that business was a very capital intensive business in, over much of the early and mid 90's, we invested quite a bit of money, ah, in that business, that business has not worked out very well for us, so ah, the rate of return on that business ah, stinks. I mean it is, it is really, really bad, ah, which kind of ah, ah, dilutes our overall return on equity numbers pretty significantly but to stop that business we ended up having to get rid of the people (laughs) that were doing that business and the last couple of years a lot of those people have left and when they've left they sold their stocks so that's, that's the only other component insider sales I think that's, that's material.

NORDBY: Is, is there anything new in the last couple of weeks on the situation in ah, in India?

SKILLING: Ah, no Ken went over, Ken Lay went over ah, I guess three weeks ago, ah, talked about to the people in the government, um, you know, it's, it's India nothing, nothing happens very quickly, now there is an important date, ah, coming up, that's November 16th. On November 16th, under the ah, terms of our contract, ah, there's a mile stone day, we are in the process of terminating our, our contract with ah, ah, Mahai (phonetic) State Electricity Board, ah, ah, consistent with that termination we present them with a bill on November 16th and what that bill is basically the total cost of facilities plus the present value of all future profits ah, from the facility. And so on November 16th they are going to get a gigantic bill and there's some thought that ah, that is a trigger point they're gonna have to do something before that, to keep that from happening, there's another potential trigger point on this, that is the Prime Minister of India is coming to the U.S. on September 19th? Is that right?

RIEKER: I think it's mid September, I.....

SKILLING: It's, it's mid September, ah, sometime and ah, he has directed his people to get this thing resolved before he comes over here because he knows it's gonna be the, about the only issue on the agenda so I, I, you know, I don't know if that will trigger some sort of ah, ah, specific proposal but ah, my guess is that the way this thing is gonna get resolved ultimately is the Government of India or the finance, the Indian financial institutions that, that are the major lenders to the facility ah, will ultimately buy it. And ah, it's my expectation that we will get full value out of it because we have good contracts, and we have government guarantees to back those

contracts.

BALIGA: Ah, you, you ah, ah, ah, kind of indicated how big that ah, bill's gonna be or how much cash am I be getting out of that?

SKILLING: Well, you know they're not gonna pay it before present value, future cash flow, we've got about \$875 million dollars in the facility, ah, you know, to include all the debt pay off and everything there's, there's \$2.4 billion dollars in the facility and I wouldn't be at all surprised if that bill looks something like \$6 billion dollars, ah, so all we want is our \$875 back. (Laughs) And then we'll see where it goes from there.

NORDBY: Ah, just one question about broadband, we, we appreciate your time and I know we should probably be winding up here, ah, how much of the broadband's capacity that, that you have sort of an ownership and control position over, do you think might be somehow technically obsolete ah, before that whole business comes back?

SKILLING: Oh, that's a tough question, I, I, I personally I don't think a whole lot, you know I, I think ah, on the long haul lines, ah, all investment in new capacity and upgraded capacity has virtually stopped right now, ah, you know, if you take the total five, yeah if you take the total five or new five or lit fiber in the U.S. right now it's only about 3% utilized. No one's investing anymore, I mean I've talked to people at AT&T, WorldCom, Level Three, ah, there will be no additional, ah, ah, equipment, no additional electronics added to those networks for a long time, if that's the case and I think this is the standard, this is what we'll see for a long time, I don't think you'll, I don't think you'll see a big change.

NORDBY: So the strategy is just to try and whittle down the fixed cost as much as possible and be ready when this comes back?

SKILLING: Yes we're gonna get the burn right, GNA burn rate and I told those guys I want them GNA positive on it, ah, basically and then come out cash basis by the 4th quarter of next year and they will be there.

NORDBY: Ah, that's really all the questions I had, ah, ah.....

BALIGA: Can I just one question to be.....

UM: Sure.

BALIGA: You, you know like when, when you talk about ah, we should view, view you as as a 25 cent growth rate is that the, is that the number that you feel comfortable with

for the next three years or so?

SKILLING: Well we're, we're not giving....long term guidance, guidance kind of , kind of gotten out of (inaudible)

(break)

BALIGA: Your market shares remain constant then you should have to do about 18 to 20 volumes as long as the growth grows faster then that you get market share growth plus margin expansion then you should get, you know, 25. Is that a fair way to look at it?

SKILLING: Ah, well our growth rate volume but it's not hotter then that.....

BALIGA: Right, then why, why should.....

(inaudible)

(Start Side B at approximately 1:07)

BALIGA: .....why should the earnings go actually lower then? If ah, if your pricing and, and if your margins (pause) have not changed and pricing has actually not been that big of an issue, and you don't take commodity risks, why, what?

SKILLING: Well you know, your growth rate in volumes have been more like a 30% per year for the last decade, ah, but we, you know, we have some other (inaudible) we have a, we have a pipe line group that's growing, that's basically flat and it's growing a little bit, ah, and so, you know, that, that will kind of dilute it, we have been investing for years in our ah retail business, it's gone earnings positive, I think we're gonna see good projectory there, we are investing in the ah, broadband business which depresses the net, the number a little bit but ah, I think it's, I think it's fair to say if we, if we can maintain a 20 to 25 % volume growth number, ah, which I think is very doable on a whole sale business, you know I, I think we're hard pressed not to maintain a 20% growth rate in earnings.

UM: Can I ask about, we, we talked a little bit about the, the impact of volatility on the merchant business, can you address the effect of, of a lower volatility environment on the outsourcing business.

SKILLING: Um, yeah ah, Jesus, we really only got volatility in the retail markets in the last year, ah, most customers in the retail markets have ah, ah, ah, seen fixed prices from the utilities so there's been essentially zero volatility in that market historically until this last year so um, you know, for all the period that we've been in that

business there's been no volatility, this last year the ah, the California thing, I'll tell you the phones are ringing off the hook, I mean ah, absolutely ringing off the hook, now if the volatility goes away, will we go back to what we had in kind of a '99, 2000 range? Yeah I think so, I mean it's, it's a big market, a value proposition in outsourcing only a small, only a portion of it is to reduce volatility for the customers, the remainder is that we can operate those facilities more cost effectively then they can so we can offer them immediate savings, ah, even in a low volatility environment so I don't, I don't think it'll impact that side very much.

NORDBY: Any other questions, we should probably wrap up, ah.....

UM: Hey, hey, I've got one more.

NORDBY: Okay, fire.

UM: Ah, just ah, I wanted to ask one more question related to this VAR issue, ah, and, and it relates to, to a competitor ah, so maybe you'd help me understand the nature of the business a little bit more, I guess the number you factored out was 60, ah, if I look at your, you know, competitor Dynegy I think their number is 10. Um, is, is, is that to say that their, their doing something better then you guys are because they're, they're generating ah, a somewhat comparable net income number by taking, you know, substantially less risk, is, is, is that the right way to understand that or, or, ah, ah, help me to understand that a little better.

SKILLING: Yeah let, let me ah, and this, this will be telling you kind of the inside, you know, dirty little secrets of our industry but ah, ah, the way this works, first of all, our volumes are, are about 7 times their volumes so you expect to see a larger VAR number on our system to maintain the, the level of business but ah, they don't include any of their power plants and their VAR calculations so essentially they've got unhedged long positions and, and by our calculations a thousand megawatts is equivalent to about 20 to 25 million of VAR exposure. So take their total megawatts, multiple it by \$25 million dollars, add it together and divide it by the market cap and you'll see that, or, or even by their earning stream, and what you will see is that we generate far more margin per dollar of VAR then anybody else in the industry by about a factor of three, which you'd expect given our relative market share.

UM: Okay and that's compute, computing everyone's VAR and an apples to apples basis.

SKILLING: Yeah because see what happens is ah, under, under most accounting conventions, if you classify an asset not as part of the portfolio but as a standard historical accounting asset position, you don't have to calculate VAR on it, ah, we don't have anything outside of our portfolio, every asset we have, except for the international,

you know, the developing countries where they're not hooked up to a network, but any asset that we have that's involved in the ah, in, in a sale of power or in natural gas to any customer in North America or Europe, ah, shows up in the portfolio and that risk is embedded in the VAR number.

UM: Yeah because that, that, it, it, based on the disclosures you see out there, it looks like they are taking substantially less risk than you guys on the disclosed numbers then earning about the same return on it.

SKILLING: Yeah, I, I think if you looked at their, if you look at their VAR, actual VAR, and look at the numbers that they're reporting recently, divided by the net income you'll see that they have actually more VAR then we have per unit of net income but then if you also include open positions, ah, on physical assets which they don't include in the VAR number, ah, the numbers, I mean we, we have far less risk than anyone else in the industry per unit of profitability. Now we're, we're the ones that pioneered the whole, the whole VAR disclosure, ah, accounting, we try to put everything from a management stand point, I can't manage if I have everything in that single bucket so I can see what kind of risk we're taking so we've always tried to throw the net as wide as possible to get everything in there so ah, you know we gotta probably, probably I gotta show you the numbers where we've adjusted for the competitors asset positions and looked at as a percentage of the net income and percentage of market cap and we're like a third of the other players in the industry.

UM: Is, is that how you.....

SKILLING: One third.

UM: Is that how you bench mark yourself as versus the competitors as that way?

SKILLING: Well that's, well that's one way, I mean we wanna see what kind of risk per unit of return that we're giving to our shareholders just to ah, just to make, see I believe with the network effect it's three times as big as the next biggest part of the industry I would expect to see that our margin per unit is significantly higher than our competitors and our margin per unit of risk should be significantly higher because it, given the dynamics of the way the industry operates, if that's not true then we're doing something wrong or I'm not pushing our people hard enough for income or we're, we're you know, we're, or it's leaking somewhere out the system so we look at those numbers and, and the numbers actually, they track exactly where you expect them to be.

UM: Ah, I'd love to see those numbers ah, apples to apples if you ever have them.

SKILLING: Okay.



NORDBY: Now, you, you send up to me or to Annie, Jeff, ah, that'll, that'll be great, ah.....

BALIGA: Ah, one, one, hey, hey Dan one second, I mean I'm, I, I was just, I, I'm kind of looking at the leakage between the 185 to 215, um, if, if I'm look, if you believe that the volume that's actually going to be greater than 20%...

SKILLING: Volume, um.....

BALIGA: ...ah, and all of the other businesses are actually going to be at least better next year than this year correct? Broadband has got to be better next year than this year, ah, your content business had gotta be better next year than this year and your trans-missional.....

SKILLING: The transmissions will probably be, the transmission will be probably be flat, you know, maybe up a percent or two but yeah.

BALIGA: Okay. And so therefore.....

SKILLING: And, and that.

UM: Go ahead.

SKILLING: The only thing you got, the other thing that you, you take into account is that it's an EBIT number so, or IBIT number and so you have to, you just have to work through the taxes and all the rest of that stuff to get to the bottom line.

UM: Okay.

SKILLING: But look, look.....

BALIGA: But let me, but I mean there's no other issues there though right, I mean there's, t here's no tax credit that are looming out there or something that's, I mean everything, that is all apples and apples.

SKILLING: Yeah it should be apples to apples.

BALIGA: Yeah. Okay so that's why the 215, I mean if there, if you're confident that the volume is going up more then 20%, ah, that's why the earnings growth should be more then 20%, is that fair?

UM: I think, I think though, that they keep in mind in the wholesale business is there's always a, ah, some of the profitability that doesn't flow all the way through to the

bottom line because we're always investing in new businesses whether it's new commodities or new regions that don't have the same early earnings, ah, magnitude that power and gas does so ah, that's almost a capital cost that flows right through earnings so...

BALIGA: Okay.

UM: ...30 % growth and volumes that the 30 % IBIT's number so wholesale net income is growing closer to, you know, the reported bottom line number at Enron.

BALIGA: Okay.

UM: And if the pipeline business and the broadband business are really small parts of that.

BALIGA: Right. Okay so I shouldn't actually be ah, worried that the, the hesitation is because the 185 includes, you know, the 15 cents on my transaction if you live this year and.....

SKILLING: Oh no, no, no, no.....

BALIGA: ....and (inaudible)

SKILLING: ....no, no, no.....

BALIGA: .....may not repeat next year.

SKILLING: No absolutely not. No, there's no hesitation for that.

BALIGA: Okay.

SKILLING: And you know ah, and one of the other things that we've been pushing, ah, we've always been a top line oriented business and, and we're, we're spending more time on cost also, yeah I, I mean if we, if we can get a 25% growth rate ah, a 20, 25% growth rate in volumes, I feel really good about our numbers next year, really good, and again, you know, we're running 60%, 60 or 70% the last couple of years so I, I feel pretty good about things right now.

NORDBY: Jeff, thanks very much.....Very much...we've, we've been eager to have this conversation and are very grateful for your time and I, you know, I think I told you in New York we've been supporting your stock down here so ah, thanks very much for ah, ah, helping us understand.

SKILLING: Ah, listen I, I appreciate ah, you know, the support you have given the stock, and I, you know, I apologize for the stock not performing better than it has, I, I don't know, I think it's one of these things, you know, the whole glass half empty half full thing but I mean we are hitting the numbers, we're beating the numbers and we will continue to hit and beat the numbers and if that happens, I think we'll get some P/E recovery, I mean we're, ah, P/E, the multiples just gotten hammered from, you know, things like India and California and all that but those things are non-issues and I, I think they're going away so I'm, I'm hoping we get some P/E recovery, ah, and we will continue to hit the numbers even if we don't get P/E recovery sooner or later (laughs) the stock price is going up because we're, I mean we're making a lot of money and we are, ah, I think demonstrating a relative competitive position, never been better, I mean we are really, really strong in these markets. So I thank, I, I appreciate your support.

NORDBY: Okay. Great. Thanks.

UM: Thanks again sir.

SKILLING: Thanks again, anytime.

UF: Thank you.

SKILLING: Thanks very much. Okay guys.

(Tape Ends)